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IN THE

Supreme Court of the United States

October Term, 1972

Memphis Light, Gas and Water Division, *Petitioner,*

v.

Federal Power Commission, *et al*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

The Memphis Light, Gas and Water Division, an agency of the City of Memphis, Tennessee, (Memphis) petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the District of Columbia Circuit entered in this case on February 18, 1972.

OPINION BELOW

The opinion of the Court of Appeals is not yet officially reported. It is printed as Appendix A to this petition.

Orders No. 404 and 404A of the Federal Power Commission, issued May 15, 1970 and July 9, 1970 respectively, are reported at 43 FPC 740 and 44 FPC 16, respectively. They are included as Appendix B to this petition.

GROUNDS OF JURISDICTION

(1) The date of the judgment and opinion of the Court of Appeals for the District of Columbia Circuit, and the time of its entry, was February 18, 1972.

(2) An extension of time for the filing of a petition for certiorari was granted by this Court on May 11, 1972, extending the time to July 17, 1972.

(3) Jurisdiction to review the judgment in question by writ of certiorari is conferred upon this Court by 28 USC §1254, 62 Stat. 928, and by Section 19(b) of the Natural Gas Act, 15 USC §717r (b).

QUESTION PRESENTED FOR REVIEW

Prior to the enactment of Section 441 of the Tax Reform Act of 1969, the Federal Power Commission possessed and exercised the power to impute to natural gas companies subject to its jurisdiction the use of liberalized depreciation, in computing federal income taxes in its cost of service, even though such a company might have exercised its tax election to use straight-line depreciation and pay the resultant higher taxes. Did the enactment of Section 441 deprive the Commission of this power with respect to properties acquired after 1969 for expansion purposes?

STATUTES AND REGULATIONS INVOLVED

Section 441 of the Tax Reform Act of 1969, 26 USC §167(1), 83 Stat. 625, 649, 653, Pub. Law 91-172 Title IV §441(a) is set out in Appendix C hereto.

STATEMENT OF THE CASE

This case involves an important question concerning the

computation of federal income taxes in the cost of service of natural gas pipe line companies subject to the jurisdiction of the Federal Power Commission. The Commission's rulings in this case and its companion case [1] would increase rates for natural gas to the customers of Texas Gas Transmission Company by $4,400,000 per year, but their effect upon all the other interstate gas pipe lines would multiply that impact many times.

The case arises upon a petition to review Orders No. 404 and 404A of the Federal Power Commission, issued in Docket No. R-387 on May 15, 1970 and July 9, 1970, respectively. Order No. 404 is designated as a "Statement of Policy" amending the Commission's General Policy and Interpretations (18 CFR Chap. 1, Subchap. A) so as to permit utilities subject to its jurisdiction to employ a "normalized" method for computing federal income taxes for accounting and ratemaking purposes, with respect to property constructed or acquired after December 31, 1969, to the extent that such property increases the productive or operational capacity of the utility and is not a replacement of existing property (i.e. "expansion property"). The effect of the Order is to permit utilities to use liberalized depreciation on post-1969 expansion property for computing actual federal income taxes, but to employ for ratemaking purposes a higher, fictional tax computed as if straight-line depreciation had been used.

Prior to the issuance of Order No. 404, the Commission had consistently held since 1964 that a regulated company was obligated to take advantage of the tax savings available through liberalized depreciation, and to "flow through" those tax

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[1] *Memphis Light, Gas and Water Division* v. *Federal Power Commission et al.* No. 24,518 CADC, decided in the same opinion of February 18, 1972.

savings by reflecting them in its cost of service.[2] The Commission had further held that, where a natural gas pipeline company exercised its taxpayer's election[3] to change from liberalized depreciation to straight-line depreciation, thereby increasing its tax costs, the available tax savings would nevertheless be imputed to it in computing its cost of service for ratemaking purposes.[4]

The Commission's only reason for changing this rule and policy in Order No. 404 was its interpretation of §441 of the Tax Reform Act of 1969. The Commission interpreted §441 as not only granting a right to regulated companies to elect straight-line depreciation for their post-1969 properties, but also forbidding the Commission to impute the use of liberalized depreciation to regulated companies making the election.

This, under the new Act, left the Commission with only two alternatives, that of requiring the company to remain on straight-line depreciation or permitting it to use liberalized depreciation and "normalize" its taxes in its cost of service computation. The "normalization" of taxes involves the use of liberalized depreciation for the payment of taxes but the use of a fictional straight-line depreciation for cost of service purposes, with the resulting tax savings going to the regulated company.

Of these two alternatives, the Commission chose to allow liberalized depreciation with normalization, as being more

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[2] *Alabama-Tennessee Natural Gas Company*, 31 FPC 208, affirmed *Alabama-Tennessee Natural Gas Company* v. *Federal Power Commission*, 359 F2d 318, cert. denied, 385 U.S. 847.

[3] Provided by §167 (e) IRC 1954, 26 USC §167(e).

[4] *Midwestern Gas Transmission Co.* 36 FPC 61, affirmed *Midwestern Gas Transmission Co.* v. *FPC*, 388 F2d 444.

beneficial to both consumers and pipelines than straight-line depreciation, and it announced its policy to permit such tax treatment thereafter, with respect to all post-1969 expansion property.

Contemporaneously with the above proceeding, the Commission was conducting proceedings with respect to rate increase applications of Texas Gas Transmission Corporation, a natural gas pipeline, at Dockets No. RP69-41 and RP70-14, and Memphis, a customer of Texas Gas, was a party thereto. In those dockets the Commission held[5] that, having permitted regulated companies to use liberalized depreciation with flow-through as to their post-1969 expansion property, it was virtually obliged to extend the same treatment to all other property of the pipeline, i.e. that acquired prior to January 1, 1970 or acquired thereafter as replacement of older property.

Memphis and others filed Petitions for Review from the Texas Gas decision with the Court of Appeals for the District of Columbia Circuit, and those petitions were heard jointly with the Petitions for Review of Orders No. 404 and 404A.

The Court of Appeals, basing its rulings squarely upon its interpretation of Section 441 of the Tax Reform Act of 1969, affirmed the Commission's Orders No. 404 and 404A, with respect to post-1969 expansion properties, but reversed and remanded its Order in the Texas Gas case relative to pre-1970 properties.[6]

REASONS FOR THE ALLOWANCE OF THE WRIT

The Court of Appeals has in this case decided an important question of federal law which has not been, but should be,

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[5] *Texas Gas Transmission Corporation* 43 FPC 824 (1970).

[6] Memphis is informed that Texas Gas Transmission Corp. will petition for certiorari as to that judgment of the Court of Appelas.

settled by this Court. The Court of Appeals has misinterpreted §441 of the Tax Reform Act of 1969, by allowing natural gas pipelines and other utilities to use liberalized depreciation with normalization with respect to all expansion properties acquired after 1969. This assures a consistently increasing cost of gas to the consumer, and is therefore precisely the opposite from what Congress intended, and thought that it had done, when it enacted the Tax Reform Act of 1969. The Court's interpretation of that Act also involves a drastic departure from a salutary rule and practice heretofore followed by the Federal Power Commission, resulting in the savings of enormous sums of money for consumers of natural gas, without hardship on the regulated companies.

THE PURPOSE OF SECTION 441 OF THE TAX REFORM ACT OF 1969 WAS TO FREEZE CURRENT DEPRECIATION PRACTICES, WITHOUT CAUSING UTILITY RATE INCREASES

The purpose of §441 is set forth succinctly in the Committee Report of the Summary of HR 1327, Tax Reform Act of 1969, prepared by the Staff of the Joint Committee on Internal Revenue Taxation, which states as follows:

> Problem.– The trends of recent years are shifts from straight line to accelerated depreciation and shifts from normalization to flow through, often against the will of the taxpayer utilities. In general, flow through to customers doubles the revenue loss involved in shifting from straight line to accelerated depreciation. It is understood that continuation of these trends would shortly lead to revenue losses of approximately $1.5 billion. Consideration of legislative action in this area is complicated by the fact that many utilities do not have effective monopolies while others do; many utilities are in growing industries while others are losing ground; many utilities compete (to the extent they face any

> competition) only with other regulated utilities while others compete with businesses not subject to governmental rate regulations. (p. 63).

The purpose of the Act was, therefore, to stop the continuation of the trend of shifts from straight-line depreciation to accelerated and from normalization to flow-through.

However, it was the oft-repeated intent of the Congress to accomplish this without an increase in utility costs to the consumers. Therefore, suggestions by the Federal Power Commission that regulated utilities be required to use straight-line depreciation were rejected, because "This would result in prompt, substantial, and wide-spread utility rate increases." House Report 91-413 Page 132. Of course, the use of accelerated depreciation with normalization results in almost the same utility increase as would the use of straight-line depreciation, since the consumers are charged as if the company had paid taxes on the straight line basis.

In order to stem the tide of shifts to flow-through depreciation without raising utility rates, both the House and the Senate agreed to "in general 'freeze' the current situation regarding methods of depreciation in the case of those companies in what are, by and large, the more flourishing utility industries." House Report No. 91-413 Page 132; Senate Report No. 91-552 Page 171. As the Bill was finally passed, Congress was satisfied that it had accomplished these purposes. The Summary of the Bill, prepared by the Staffs of the Joint Committee on Internal Revenue Taxation and the Committee on Finance stated:

> The Bill substantially forestalls the entire revenue loss that the continuation of existing

> trends would have been made almost inevitable. It does so in a way that (with very few exceptions) will require no increase in utility rates because of the tax laws, since by and large, it merely takes the various situations as it finds them and freezes those situations. (p.73).

The format of the legislation is an amendment to Section 167 of the Internal Revenue Code relating to depreciation, by defining reasonable allowances for depreciation of utility property. With respect to pre-1970 property, a utility is permitted to use liberalized depreciation with flow-through only if it was doing so for its July, 1969 accounting period.[7] With respect to post-1969 property, the utility may use liberalized depreciation with flow-through if such method was used for its July, 1969 accounting period.[8] By permitting the use of flow-through only by companies which were already using it in July 1969, the Act accomplished the "freeze" which both House and Senate reports mentioned.

THE NEW ELECTION PROVISION DOES NOT INHIBIT THE COMMISSION'S POWER TO IMPUTE ACCELERATED DEPRECIATION WITH FLOW-THROUGH

The Act further provides in Section (1) (4) (A)

> (4) Special rules as to flow-through method.–
>
> (A) Election as to new property representing growth in capacity. – If the taxpayer makes an election under this subparagraph within 180 days after the date of

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[7] Sec. 441 (1) (1); 26 USC §167(1) (1)

[8] Sec. 441(1) (2); 26 USC §167(1) (2)

> the enactment of this subparagraph in the manner prescribed by the Secretary or his delegate, in the case of taxable years beginning after December 31, 1970, paragraph (2) (C) shall not apply with respect to any post-1969 public utility property, to the extent that such property constitutes property which increases the productive or operational capacity of the taxpayer with respect to the goods or services described in paragraph (3) (A) and does not represent the replacement of existing capacity.

The difficulty in the interpretation of the Act arises over the last-quoted section. The Senate Finance Committee Report, commenting on an interim version of the quoted section, remarked that, once the election was made, "since the company would no longer be permitted to use accelerated depreciation (unless the agency later permits to normalize), the agency would not be able to impute the use of accelerated depreciation with flow through." (p. 174). It was this statement which convinced the Court of Appeals that "Congress intended thereby to preclude regulatory agencies from imputing flow-through to any regulated utility exercising this election with respect to its post-1969 expansion property." (Slip Op. p. 7).

The determination of the issue in this case depends upon whether this remark in the Senate Report is authoritative. Petitioners contend that it is not for the following reasons:

1. If the regulatory agencies are powerless to control the exercise of this election by imputing flow-through, then the regulated companies will take advantage of this opportunity to increase their revenues, and this must inevitably result in substantial increases to consumers.

2. Such a practice by the regulated industries would not amount to a "freeze" of existing depreciation practices, but a

drastic, and for the consumers a disastrous, modification of depreciation practices.

3. The statement in the Senate Report does not purport to explain or define the terms of the Bill itself, but rather interprets the impact of the regulation upon the powers of the regulatory agencies operating under different statues.

4. It construes an Internal Revenue Act as an amendment to and a modification of the Natural Gas Act and all other federal and state utility acts, and a modification which seriously impinges upon the power of the regulatory agencies to protect the consumers against unnecessary and unreasonable costs.

5. It would confer upon regulated utilities a power, exercisable solely in the self-interest of the utility, to violate the

> essential precept of regulatory law that no income tax allowance should be permitted except for taxes actually paid.[9]

The above propositions, taken together, make an overwhelming argument against the persuasiveness of the Committee's remark, relative to the interim version of the Bill. Had the Congress intended so far-reaching a change in hitherto established regulatory principles, it is reasonable to suppose that it would have been spelled out clearly in the text of the Act, and not left to a casual comment on an incomplete Bill. The Court of Appeals for the Fifth Circuit, in construing a closely related question has stated:

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[9] *Southern Louisiana Area Rate Case*, 40 FPC 530, 581; *Federal Power Commission* v. *United Gas Pipe Line Company*, 386 U.S. 237, 244.

> Given the long reach of the Natural Gas Act as liberally interpreted by the Supreme Court, and weighing the consumer-oriented objectives of that Act against the Section 167 objective of promoting plant expansion by postponing the timing of tax payments, we conclude: It is unlikely to suppose that Congress amended the Natural Gas Act by a reference in the Internal Revenue Code; it is unreasonable to read Section 167 as a mandate reducing the Commission's responsibility to fix fair rates according to its usual ratemaking policies in favor of the consumer. *Alabama-Tennessee Natural Gas Company* v. *Federal Power Commission,* 359F2d 318, 335 (1966) cert. denied 385 U.S. 847.

Furthermore, the gloss added by the Committee's comment imports to the clear words of the statute an important significance which the words themselves do not bear. This Court has held that

> . . . [W]here the language of the enactment is clear and construction according to its terms does not lead to absurd or impracticable consequences, the words employed are to be taken as the final expression of the meaning intended. And in such cases *legislative history may not be used to support a construction that adds to or takes from the significance of the words employed. U.S. v. Mo. & P.R. Co.* 278 U.S. 269, 278, 73 LEd. 322, 377, 49 SCt. 133. (Emphasis added)

Again, this Court has held that the legislative history of a statute may not be taken as giving to it "a meaning not fairly within its words." *St. Louis I M & S Ry* v. *Craft,* 237 U.S. 648,

661; 59 LEd. 660, 35 SCt. 704, 707. Nor can such legislative reports be resorted to in order to construe a statute contrary to its natural import. *U.S.* v. *Shreveport Grain & Elevator Co.*, 287 U.S. 77, 77 LEd. 175, 53 SCt. 42. And a construction of a statute which would produce incongruous results is to be avoided. *CIR* v. *Builder*, 289 F2d 291, 298 (CA3, 1969).

THE NEW ELECTION IS AN EXTENSION OF THE STANDARD DEPRECIATION ELECTION, AND IS SUBJECT TO THE SAME REGULATORY TREATMENT

Once the election provision is freed from the unfortunate Committee remark, it begins to make sense. It then becomes simply an extension of the similar election which has always been provided in Section 167(e) of the 1954 Internal Revenue Code.[10]

The taxpayer election is not, in the new Act, restricted to a change to straight-line depreciation (as in §167(e)) but also includes "a subsection (1) method," which is "any method determined by the Secretary or his delegate to result in a reasonable allowance under subsection (a), other than (i) a declining balance method (ii) the sum of years-digits method or (iii) any other method allowable solely by reason of the application of subsection (b) (4) or (j) (1) (c)."[11] This would

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[10] "(1) Change from declining balance method. -In the absence of an agreement under subsection (d) containing a provision to the contrary, a taxpayer may at any time elect in accordance with regulations prescribed by the Secretary or his delegate to change from the method of depreciation described in subsection (b) (2) [declining balance] to the method described in subsection (b) (1) [straight line]."

[11] §441(1) (3) (F); 26 USC §167 (1) (3) (F).

allow, for instance, a change to a unit-of-production method of depreciation if circumstances so warranted.

However, if the election provided in the new Act is *in pari materia* with the standard election of Section 167(e), then its exercise is subject to the same limitations as the Courts have held to apply to natural gas companies seeking to change from liberalized depreciation to straight line. In *Midwestern Gas Transmission Co.* 36 FPC 61 (1966) the company had made an election under Section 167 (e) to return to straight-line depreciation, following a Commission decision [12] that liberalized depreciation tax savings should be passed along to the customer. The Commission held that such action constituted a violation of Midwestern's duties under the Natural Gas Act, and it proceeded to impute to Midwestern, for purposes of its cost of service, the tax savings which would have been realized had it taken advantage of liberalized depreciation. In other words, the Commission flowed through the benefits of liberalized depreciation to Midwestern's customers, even though Midwestern had exercised its taxpayer's election to switch to straight-line depreciation. The Commission was affirmed in *Midwestern Gas Transmission Co.* v. *FPC* 388 F2d 444 (CA 7, 1968). The Court said:

> Here it seems to us quite reasonable and logical to recognize as inherent in the Commission the duty and requirement to exercise its expertise in evaluating the entire tax effect of managerial judgment. If such elected tax policies do not fairly indicate a reasonable and prudent business expense, which the consuming public may reasonably be required to bear, following the required hearing and review procedures, then

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[12] *Alabama-Tennessee Natural Gas Co.* 31 FPC 208, affirmed 359 F2d 318.

federal regulatory intervention is required. 388 F2d 448

The Court below recognized "the Commission's duty under the Natural Gas Act to require regulated utility companies such as Texas Gas . . . to set rates which reflect actual expenditures alone with respect to such property. According to Congress, the only appropriate tax allowance for ratemaking purposes for a company such as Texas Gas, which has been using liberalized depreciation with flow-through with respect ot its pre-1970 and post-1969 non-expansion property, is the income taxes actually paid." (Slip Op. p. 20). The only reason for the Court's failure to apply this rule to the post-1969 property of Texas Gas was its understanding that the election provision, as interpreted by the Senate Committee's remark, had abrogated that rule of law with respect to the company's post-1969 expansion property.

The foregoing authorities clearly establish the rule that a regulated public utility must exercise all available tax economies and that regulating agencies have the power and duty to see that this is done. There is no place in the scheme of the Natural Gas Act for the use of fictitious taxes which inflate a cost of service upon which rates are determined. It is not reasonable to suppose that this salutary principle of regulation was intended to be abrogated by Congress in an Internal Revenue Act which totally failed to spell out any such intent or purpose; *a fortiori* when the legislative history of the Act makes clear the purpose of Congress to "freeze' the current situation regarding methods of depreciation" and reveals the opinion of the Legislators that the Act merely forestalls a revenue loss and does so without requiring an increase in utility rates.

Yet the ruling of the Commission in Orders No. 404 and 404A, and the Opinion of the Court of Appeals affirming those Orders, are based upon precisely that understanding of the intent and effect of Section 441 of the Tax Reform Act of 1969. It is clear, furthermore, that the Commission would not

have made the decision it did in the Texas Gas case with respect to pre-1970 property, had it not felt bound to do so because of its interpretation of the Tax Reform Act in Orders No. 404 and 404A.[13]

CONCLUSION

The effect of the decision of the court below is of major importance in the administration of the Natural Gas Act. In fact, the question presented by this case has ramifications throughout the field of public utility regulation since the principles of this case appear fully applicable to electric utilities regulated by the Commission under the Federal Power Act, 16 U.S.C. 791a-825r. Also, the issue is present in State commission cases and while the decision of this Court in this case may not have a binding effect on State commissions a decision by this Court of the question will undoubtedly have its influence. In brief, the question presented is one of major concern and its resolution will affect by many millions of dollars the rates to be paid by the consuming public for utility services.

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[13] *Texas Gas Transmission Corp.* 43 FPC 824

WHEREFORE, the petition for the writ of certiorari should be granted.

Respectfully submitted,

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July 17, 1972

Attorneys for Memphis Light, Gas and Water Division

APPENDIX A

Notice: This opinion is subject to formal revision before publication in the Federal Reporter or U.S.App.D.C. Reports. Users are requested to notify the Clerk of any formal errors in order that corrections may be made before the bound volumes go to press.

United States Court of Appeals

FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 24,517

MEMPHIS LIGHT, GAS AND WATER DIVISION, PETITIONER

v.

FEDERAL POWER COMMISSION, RESPONDENT

TEXAS GAS TRANSMISSION CORPORATION,
TENNESSEE VALLEY MUNICIPAL GAS ASSOC., ETC., INTERVENORS

No. 24,518

MEMPHIS LIGHT, GAS AND WATER DIVISION, PETITIONER

v.

FEDERAL POWER COMMISSION, RESPONDENT

TEXAS GAS TRANSMISSION CORPORATION,
AMERICAN PUBLIC GAS ASSOCIATION, INTERVENORS

No. 24,602

TENNESSEE VALLEY MUNICIPAL GAS ASSOCIATION, ET AL., PETITIONERS

v.

FEDERAL POWER COMMISSION, RESPONDENT

TEXAS GAS TRANSMISSION CORPORATION, INTERVENOR

No. 24,632

PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK, PETITIONER

v.

FEDERAL POWER COMMISSION, RESPONDENT

TEXAS GAS TRANSMISSION CORPORATION, INTERVENOR

Petitions for Review of Orders of the Federal Power Commission

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Judgment entered this date

Decided February 18, 1972

Mr. George E. Morrow, with whom *Mr. Reuben Goldberg* was on the briefs, for petitioner in Nos. 24,517 and 24,518.

Mr. Morton L. Simons for petitioner in No. 24,632.

Mr. J. Richard Tiano, Assistant Solicitor, Federal Power Commission, with whom *Messrs. Gordon Gooch,* General

Counsel, and *Abraham R. Spalter,* Assistant General Counsel, Federal Power Commission, were on the brief, for respondent. *Mr. Israel Convisser,* Attorney, Federal Power Commission, also entered an appearance for respondent.

Mr. Christopher T. Boland, with whom *Mr. Richard J. Connor* was on the brief, for intervenor Texas Gas Transmission Corporation. *Mr. George J. Meiburger* also entered an appearance for intervenor Texas Gas Transmission Corporation in Nos. 24,517 & 24,518.

Mr. Reuben Goldberg entered an appearance for petitioner in No. 24,602.

Mr. Charles F. Wheatley, Jr., was on the brief for intervenor American Public Gas Association in No. 24,518.

Before FAHY, *Senior Circuit Judge,* and ROBINSON and WILKEY, *Circuit Judges.*

WILKEY, *Circuit Judge*: These two sets of cases, consolidated for review, involve a determination as to the impact of Section 441(a) of the Tax Reform Act of 1969,[1] relating to the methods of depreciation for regulated utilities, on two types of utility property: (1) post-1969 expansion property and (2) pre-1970 and post-1969 non-expansion property.[2] The impact of Section 441(a) on post-1969 ex-

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[1] Int. Rev. Code of 1954, § 167(1), *as amended* Publ. L. 90-26, §§ 1, 2(b), 81 Stat. 57, 58 (1967); Publ. L. 91-172, § 521 (a), (d), 83 Stat. 625, 649, 653 (1969).

[2] Section 441(a) of the 1969 Tax Reform Act defines "pre-1970" property as "property which was public utility property in the hands of any person at any time before January 1, 1970." [Int. Rev. Code of 1954, § 167(1)(3)(B)]. Property which is not pre-1970 is considered "post-1969" property [Int. Rev. Code of 1954, § 167 (1)(3)(C)]. "Expansion" property is the term employed to denote that property "which increases the productive or operational capacity of the taxpayer," while "non-expansion" property refers simply to

pansion property—the subject of FPC Orders No. 404 and 404-A, issued, respectively, 15 May 1970 and 9 July 1970, and cases no. 24,518 and 24,602 here—will be considered first, followed by a determination of its effect on pre-1970 and post-1969 non-expansion property—the subject of FPC Opinions No. 578 and 578-A and accompanying orders, issued 3 June 1970 and 21 July 1970, respectively, and cases no. 24,517 and 24,632 here.

I.

A.

Congress specifically provided for the proper depreciation treatment of post-1969 utility expansion property in Section 441(a) of the Tax Reform Act of 1969 as follows:

> (A) *Election as to new property representing growth in capacity.*—If the taxpayer makes an election under this subparagraph within 180 days after the enactment of this subparagraph in the manner prescribed by the Secretary or his delegate, in the case of taxable years beginning after December 31, 1970, paragraph (2)(C) [concerning liberalized depreciation with flow-through] shall not apply with respect to any post-1969 public utility property, to the extent that such property constitutes property which increases the productive or operational capacity of the taxpayer with respect to the goods or services described in paragraph (3)(A) and does not represent the replacement of existing capacity.[3]

This provision indicates that Congress intended to, and did, prescribe specifically the appropriate tax depreciation treatment for post-1969 expansion property of utilities such as involved in the cases here. It permits a regulated utility such as Texas Gas Transmission Corporation,

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that property which replaces the existing plant of a taxpayer [Int. Rev. Code of 1954 § 167(1)(4)(A)].

[3] Int. Rev. Code of 1954, § 167(1)(4)(A).

an intervenor in these cases, to make an election, within 180 days after enactment of this provision, *not* to have liberalized depreciation with flow-through [4] apply with respect to its post-1969 expansion property. That is, such a method would no longer be considered a "reasonable allowance" for tax depreciation purposes within the meaning of the Internal Revenue Code of 1954.[5]

The legislative history accompanying Section 441(a) of the 1969 Tax Reform Act supports this interpretation. The report of the Senate Finance Committee states in relevant part:

> The [Senate] committee amendments, while in most respects the same as the House provisions, differ in one principal area. The amendments permit an election to be made within 180 days after the date of enactment of the bill for a utility covered by this provision to shift from the flow-through to the straight-line method, *with or without the permission of the appropriate regulatory agency, or permit it with the permission of the regulatory agency to shift to the normalization method* (that is, come under general rules of the bill).
>
> *This election applies both as to new and existing property.* . . . Since the company would no longer be permitted to use accelerated depreciation (unless the agency later permits it to normalize), the agency

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[4] By utilizing liberalized depreciation in computing its income tax, a utility obtains a larger deduction, and thus pays less income tax, at least initially, and, in the case of expanding or steady plants, overall, than it would if it used straight-line depreciation. Under the "flow-through" method of liberalized depreciation, a utility is allowed to recoup from its customers by means of its rates only the taxes it *actually* pays; under "normalization," however, it is allowed to recoup the higher taxes it would pay (but actually does not) if it were using straight-line depreciation.

[5] Int. Rev. Code of 1954, § 167(1)(2)(C).

> would not be able to impute the use of accelerated depreciation with flow-through.[6]

In conference, the *election right was restricted to apply only to post-1969 expansion property.* As the Conference Report indicates:

> The conference substitute (sec. 441 of the substitute and sec. 167(1) of the code) *follows the Senate amendment except that* the special provision referred to in (e) above is stricken and *the 180-day election (item (d), above) is modified to apply to new property and not to replacement property.* Even in the case of new property, however, the right to change over from the flowthrough method is to be available only to the extent the new property increases the productive or operational capacity of the company.[7]

It is clear, then, that Congress intended to, and did in fact, provide regulated utilities such as Texas Gas with an option to abandon flow-through for rate-making purposes in regard to post-1969 expansion property and substitute in its place either (1) straight-line depreciation, with or without the permission of the relevant regulatory agency or (2) accelerated depreciation with normalization,[8] with

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[6] S. Rep. No. 552, 91st Cong., 1st Sess. 173-74 (1969) (emphasis added).

[7] Conf. Rep. No. 782, 91st Cong., 1st Sess. 312-13 (1969) (emphasis added).

[8] Under normalization, taxes for *ratemaking purposes* are determined on the basis of straight-line depreciation, while for *tax purposes* liberalized depreciation is used. The difference between the taxes which would be payable under straight-line depreciation and the taxes payable under liberalized depreciation is placed into a deferred tax reserve account by the taxpayer. The FPC requires that this reserve account be deducted from the rate base. Accordingly, the rates charged customers are lower by the amount of the return on this reserve account which would otherwise be charged if the reserve account were not deducted from the rate base.

the permission of the appropriate regulatory agency. It is also clear that Congress intended thereby to preclude regulatory agencies from imputing flow-through to any regulated utility exercising this election with respect to its post-1969 expansion property.[9]

B.

The basic issue in this set of cases, therefore, is whether the FPC was correct in its Orders No. 404 and 404-A in interpreting the Tax Reform Act of 1969 as depriving it of the power to impute the use of liberalized depreciation with flow-through for rate-making purposes to a utility making the election under Section 441(a)[10] to abandon flow-through with respect to its post-1969 expansion property. Clearly, it is the duty of the FPC, under its Congressional mandate, the Natural Gas Act,[11] to ensure the

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[9] As the Senate Finance Committee Report states with respect to a company exercising its right to abandon flow-through under the 180-day election provision, ". . . Since the company would no longer be permitted to use accelerated depreciation (unless the agency later permits it to normalize), *the agency would not be able to impute the use of accelerated depreciation with flow-through.*" [See note 6, *supra*, at 174 (emphasis added)] While the availability of the 180-day election option was subsequently limited in conference to apply only to post-1969 utility expansion property, the Conference Report stated that "[t]he conference substitute (Sec. 441 of the substitute and Sec. 167(1) of the code) *follows the Senate amendment* except that "the 180-day election . . . is modified to apply to new property and not to replacement property." [See note 7, *supra* (emphasis added)] This indicates that the Senate rationale, cited above, is controlling as to post-1969 expansion property, thus preventing the Commission from imputing liberalized depreciation with flow-through to Texas Gas' post-1969 expansion property.

[10] See note 3, *supra*.

[11] 15 U.S.C. §§ 717-717(w) (1954).

continued availability of natural gas in interstate commerce for eventual sale to consumers at the lowest practicable rate. As the Fifth Circuit had occasion to observe:

> The central principle in the regulation of the natural gas industry around which all ratemaking revolves is "the intention of Congress that natural gas shall be sold in interstate commerce for resale for ultimate public consumption . . . at the lowest possible reasonable rate consistent with the maintenance of adequate service on the public interest."
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> This is the language of Section 7(c) of the Natural Gas Act as originally enacted in 1938. The provision was deleted when the subsection was amended in 1942 but, as the Supreme Court has held, the amendment was not intended to change the congressional purpose of the Act; the "primary aim of this legislation was to protect consumers against exploitation at the hands of natural gas companies." *Federal Power Commission* v. *Hope Natural Gas Company*, 1944, . . . Again, as Justice Clark reiterated twenty-five years later: "The Act was so framed as to afford consumers a complete, permanent and effective bond of protection from excessive rates and charges." *Atlantic Refining Company* v. *Public Service Commission*, 1959, . . .[12]

However, the FPC may not remain oblivious to the wishes of Congress as expressed in forms other than amendments to or deletions from the Natural Gas Act. By means of Section 441(a) of the 1969 Tax Reform Act, Congress has provided regulated utilities such as Texas Gas with an absolute right of election to abandon flow-through with respect to their post-1969 expansion property. Furthermore, we do not have the situation presented in *Alabama-Tennessee Natural Gas Co.* v. *FPC*,

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[12] *Alabama-Tennessee Natural Gas Co.* v. *Federal Power Commission*, 359 F.2d 318, 331 (5th Cir.), *cert. denied* 385 U.S. 847 (1966).

supra, where the court was able to find "no evidence that at the time Section 167 [of the Internal Revenue Code] was enacted Congress even focused on the problem in terms of reducing the dimensions of the Federal Power Commission's regulatory responsibility to protect consumers from excessive rates. . . ."[13] Rather, investigation of the legislative history regarding Section 441(a) of the Tax Reform Act of 1969 reveals that Congress was well aware of the implications of permitting regulated utilities an election to abandon liberalized depreciation with flow-through with respect to the their post-1969 expansion property.[14] As such, the FPC was not remiss in the performance of its statutory duty in permitting Texas Gas to abandon flow-through in regard to its post-1969 expansion property, as expressly provided by the language of Section 441(a) of the 1969 Tax Reform Act.

C.

The FPC's Orders No. 404 and 404-A, indicating that it would continue the policy adopted in *Alabama-Tennessee Natural Gas Co., supra,*[15] of deducting the amounts in the accrued deferred tax account from the rate base and not considering such balances as part of capitalization in rate proceedings before it, is a statement of policy based essentially on an interpretation of Section 441(a) of the 1969 Tax Reform Act. Thus, under the pertinent provi-

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[13] *Id.,* at 332. As the court also observed, "Occam's razor slices through the arguments based on legislative history and congressional intent. Either Congress did not consider the concrete problem the case presents or, if it did, Congress decided to let sleeping dogs lie." [*Id.,* at 335]

[14] See notes 6 & 7, *supra.*

[15] 31 FPC 208, *modified* 31 FPC 928 (1964), *aff'd sub nom. Alabama-Tennessee Natural Gas Co.* v. *Federal Power Commission,* see note 12, *supra.*

sions of the Administrative Procedure Act,[16] it was properly issued without notice or opportunity for hearing, since it was not the result of a rulemaking proceeding.

While Memphis Light contends that Orders No. 404 and 404-A of the Commission denied them the benefits of liberalized depreciation with flow-through accounting and ratemaking in regard to their post-1969 expansion property, they misdirect their attack. Instead of the Commission's orders here, what resulted in the denial of liberalized depreciation with flow-through was the election by Texas Gas to abandon such depreciation, as it was specifically entitled to do under Section 441(a) of the 1969 Tax Reform Act. Texas Gas made this election in a letter to the Commissioner of Internal Revenue dated 8 June 1970, a copy of which was transmitted to the FPC dated 10 June 1970. At this juncture, the *only* options available to the Commission were either to do nothing and thereby leave Texas Gas on straight-line depreciation or to permit it to use liberalized depreciation with normalization. And the FPC chose the latter.

The Commission's Orders No. 404 and 404-A, then, were nothing more than statements of FPC policy interpreting the mandate of Congress as expressed in Section 441(a) of the Tax Reform Act of 1969. As such, they were clearly exempt from the notice and opportunity for hearing requirements for rulemaking provided under the Administrative Procedure Act. While it is true that the FPC's interpretative rulings here may have significant economic consequences on Memphis Light and other ratepayers in the long run, such a statement of policy is specifically exempted by the Administrative Procedure Act from the need for prior notice or opportunity for a hearing:

> Except when notice or hearing is required by statute [not relevant here], this subsection does not apply—

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[16] 5 U.S.C. § 553(b)(A) (1966).

(A) to interpretative rules, *general statements of policy,* or rules of agency organization, procedure, or practice. . . .[17]

D.

The case law does not support the petitioners' assertion that notice and opportunity for hearing were required in this set of cases—24,518 and 24,602. While interested parties might argue the validity of the FPC's interpretation of Congressional purpose as expressed in Section 441(a) of the Tax Reform Act of 1969, such an opportunity is not required by the Administrative Procedure Act prior to issuance of such interpretations by an administrative agency.[18]

The petitioners' argument that the FPC, as a result of the issuance of its Orders No. 404 and 404-A, has changed its policy in *Alabama-Tennessee Natural Gas Co., supra,* is incorrect. Only those utilities that made the election provided by Section 441(a) of the 1969 Tax Reform Act to abandon flow-through with respect to their post-1969 expansion property are affected by the Commission orders here at issue. The case of *Texaco, Inc.* v. *FPC*[19] is inapposite, since the switch from simple to compound interest which the Commission ordered in that case was one involving consideration of, *inter alia,* current interest rates and trends, the impact on individual companies and the effect of increased contingent liabilities on the ability of the companies affected to acquire new equity or debt capital. In contrast, the instant set of cases, aside from the question of the validity of the FPC's interpretation of

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[17] *Id.* (emphasis added).

[18] See *Id.;* also, *Gibson Wine Co.* v. *Snyder,* 90 U.S. App. D.C. 135, 194 F.2d 329 (1952); *Garelick Manufacture Co.* v. *Dillon,* 114 U.S. App. D.C. 218, 313 F.2d 899 (1963).

[19] 412 F.2d 740 (3rd Cir. 1969).

Section 441(a) of the 1969 Tax Reform Act, involved no need for further consideration by the Commission as to what regulatory policy would result in a lower rate for Memphis Light and other ratepayers. The impact of liberalized depreciation with normalization as opposed to that of straight-line depreciation—the only choice open to the FPC under the election provision for regulated utilities such as Texas Gas contained in Section 441(a) of the 1969 Tax Reform Act, had already been fully considered and resolved in prior cases in favor of liberalized depreciation with normalization.[20]

The other principal case relied upon by the petitioners here, *National Motor Freight Traffic Association* v. *United States*,[21] is likewise inapposite. In that case, the Interstate Commerce Commission, after Congress had vested reparations authority in the courts in cases involving motor carriers, had announced an informal process for restoring to

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[20] See *Northern Natural Gas Co.*, 25 FPC 431 (1961), in which the Commission found that the use of liberalized depreciation with normalization provided tax benefits not available under straight-line depreciation. These benefits were shared with the ratepayers if a less-than-normal or zero rate of return was allowed on the tax reserve or if it was completely deducted from the company's rate base (as here) [25 FPC at 438-441]. In addition, the Commission in the instant set of cases, in denying petitions for rehearing, stated:

> The use of straight-line depreciation eliminates the possibility of tax deferrals to natural gas pipeline companies. On the other hand, liberalized depreciation with normalization may generate substantial tax deferrals. *The benefits of these tax deferrals are shared,* although admittedly not necessarily in equal proportions, *by the company and its customers* by treating such amounts as rate base deductions. [44 FPC 16 (1970) (emphasis added)]

[21] 268 F. Supp. 90 (D.D.C., three judges, 1967), *aff'd* 393 U.S. 18 (1968).

shippers past charges which were currently agreed by the carrier to have been illegal. This procedure did not relate to any substantive power specifically granted the ICC and the court in that case held that a rulemaking process was required to ascertain whether such authority existed in the first place and, if so, whether it should be exercised. In such a situation, unlike that presented by the set of cases at hand, the creation of procedures was an integral part of a substantive determination that could not be made without notice and opportunity for hearing. Here, however, since the only option open to the FPC was a choice between leaving a utility electing to abandon flow-through with respect to its post-1969 expansion property under Section 441(a) of the 1969 Tax Reform Act on straight-line depreciation, and, permitting it to use liberalized depreciation with normalization, hence, there was no need for prior notice or a hearing. Prior decisions of the Commission had already resolved this issue in favor of liberalized depreciation with normalization.[22]

II.

The second set of cases—24,517 and 24,632—involves the validity of the FPC's decision in its Opinions No. 578 and 578-A and accompanying orders, permitting Texas Gas to change from liberalized depreciation with flow-through to such depreciation with normalization in regard to its pre-1970 and post-1969 *non*-expansion property.

Section 441(a) of the Tax Reform Act of 1969 amended the Internal Revenue Code of 1954 by adding subsection (1), "Reasonable allowance in case of property of certain utilities," to Section 167 of the IRC. Section 441(a) distinguishes between two types of utility property: (1) pre-1970 and post-1969 non-expansion property and (2) post-1969 expansion property. With respect to the latter type,

[22] See note 20, *supra*.

Section 441(a) permits utilities using liberalized depreciation with flow-through to elect within 180 days of the enactment of Section 441(a) to shift either to straight-line depreciation of their own volition or to liberalized depreciation with normalization with the permission of the appropriate regulatory agency. Texas Gas exercised this option with respect to its post-1969 expansion property and received the FPC's permission to employ liberalized depreciation with normalization—the validity of which is treated in I., above.

In the instant set of cases, the determination of whether the FPC was correct in permitting Texas Gas to shift from liberalized depreciation with flow-through to similar depreciation with normalization with respect to its pre-1970 and post-1969 non-expansion property requires, first, a review of Section 441(a) and its legislative history to ascertain the intent of Congress here and, second, a consideration of the validity of the Commission's decision in light of this Congressional intent.

A.

Section 167(a) of the Internal Revenue Code of 1954 [23] provides that a taxpayer is entitled to a "reasonable allowance" for a tax depreciation deduction. Section 441(a) of the 1969 Tax Reform Act specifies the appropriate methods for computing this "reasonable allowance" for pre-1970 and post-1969 non-expansion property in the case of regulated utilities such as Texas Gas. Under Section 441(a), a "reasonable allowance" may be computed in either of two ways: one, a "subsection (1) method," refers to the straight-line method of depreciation, while the other is "the applicable 1968 method for such property," but "only if the taxpayer uses a normalization method of

[23] Int. Rev. Code of 1954, § 167(a), ch. 736, 68A Stat. 51, *as amended* Publ. L. 89-800, § 2, 80 Stat. 1513 (1966).

accounting."[24] Section 441(a), however, provides an exception to the normalization requirement for using the second method by allowing a utility using the flow-through method to continue doing so.[25]

The right conferred on regulated utilities such as Texas Gas by Section 441(a) of the 1969 Tax Reform Act to make an election within 180 days of the enactment of Section 441(a) to shift from liberalized depreciation with flow-through to either straight-line depreciation or, with the approval of the appropriate regulatory agency, liberalized depreciation with normalization with respect to their post-1969 expansion property, as discussed in I., *supra*, does not, however, apply to pre-1970 and post-1969 *non*-expansion property.

The legislative history accompanying the enactment of Section 441(a) clearly reveals the intent of Congress that the right of election provided utilities to shift from liberalized depreciation with flow-through either to straight-line or to liberalized depreciation with normalization be confined simply to post-1969 expansion property. While the progress of Section 441(a) through both houses of Congress and in conference reveals the existence of differences as to what types of property should be made eligible under the election provision, *the final version of the bill limits the applicability of the right of election to post-1969 expansion (non-replacement) property alone.*

At the first stage, the House Report indicated:

> Your committee's bill provides that, in the case of *existing* property, the following rules are to apply:
>
> (1) If straight line depreciation is presently being taken, then no faster depreciation is to be permitted as to that property.

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[24] See note 1, *supra*, at § 167(1)(A).

[25] *Id.*, at § 167(1)(B).

> (2) If the taxpayer is taking accelerated depreciation and is "normalizing" its deferred taxes, then it must go to the straight line method unless it continues to normalize as to that property.
>
> (3) If the taxpayer is taking accelerated depreciation and is flowing through to its customers the benefits of the deferred taxes, then the taxpayer must continue to do so, unless the appropriate regulatory agency permits a change as to that property.[26]

Thus, under the House version of the bill, Texas Gas, since it had been using accelerated depreciation with flow-through, would have been required to continue doing so with respect to its "existing" (including replacement) property unless the Commission permitted otherwise. If this had been the law enacted, the Commission's and Texas Gas' position here would have been clearly justified. But, as we shall see, the law actually passed was significantly changed.

The bill as reported by the Senate Finance Committee gave regulated utilities using liberalized depreciation with flow-through an election to abandon that method of depreciation both for "pre-1970" property (a change from "existing" property in the House version) and "post-1969" property ("other" property in the House bill). The Senate Report states in regard to the altered right of election:

> The [Senate] committee amendments, while in most respects the same as the House provisions, differ in one principal area. The amendments permit an election to be made within 180 days after the date of enactment of the bill for a utility covered by this provision to shift from the flow-through to the straight-line method, with or without the permission of the regulatory agency, or permit it with the permission

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[26] H.R. Rep. No. 413 [To Accompany H.R. 13270], 91st Cong., 1st Sess. 132-33 (1969) (emphasis added).

of the regulatory agency to shift to the normalization method (that is, to come under general rules of the bill). This election applies both as to new and *existing* property.[27]

Under the Senate version of the bill, therefore, Texas Gas would have been permitted to shift from liberalized depreciation with flow-through either to straight-line depreciation or, with the FPC's approval, to liberalized depreciation with normalization.

However, in conference, it was agreed that this right of election would be restricted to apply to post-1969 *expansion property only.* The Conference Report states:

1. *Depreciation allowed regulated industries (sec. 167 of the code)*

The House bill provides that in the case of certain regulated industries (the furnishing or sale of . . . gas through a local distribution system, . . . and transportation of gas by pipeline) a taxpayer is *not permitted* to use accelerated depreciation *unless it "normalizes"* the current income tax reduction resulting from the use of such accelerated depreciation. . . .

This rule is not to apply in the case of a taxpayer that is at present flowing through the tax reduction to earnings for purposes of computing its allowable expenses on its regulated books of account. Also, if the taxpayer is now using straight line depreciation as to any public utility property it may not change to accelerated depreciation as to that property.

The Senate amendments make the following changes in the House bill: . . . (d) *an election is permitted to be made within 180 days after the date of enactment by a company at present on flowthrough to come under the rules of the bill;* . . .

The conference substitute (sec. 441 of the substitute and sec. 167(1) of the code) follows the Senate amendment except that the special provision referred to in

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[27] See note 6, *supra* (emphasis added).

(e) above is stricken and the 180-day election (item (d), above) is modified to apply to new property and not to replacement property. Even in the case of new property, however, the right to change over from the flowthrough method is to be available only to the extent the new property increases the productive or operational capacity of the company.[28]

Thus, Texas Gas is unable to invoke the election provision of Section 441(a) to abandon liberalized depreciation with flow-through with respect to its "existing" (including replacement) property for two reasons: first, since Texas Gas has been employing liberalized depreciation with flow-through, it is specifically prohibited, under the final version of the bill, from abandoning such depreciation (see the second paragraph of the Conference Report, *supra*); and, second, since the right of election was restricted to apply to post-1969 expansion property *only*, Texas Gas may not seek to circumvent this restriction by applying it to its pre-1970 and post-1969 *non*-expansion property—the subject of this set of cases (24,517 and 24,632).

What the Commission does by its decision in this set of cases, then, is to produce an effect precisely contrary to that envisioned by Congress in enacting the Tax Reform Act of 1969. This effect was considered by Congress in its deliberations on the appropriate scope for the right of election provided by Section 441(a), both in terms of its impact on rates and on tax revenues, and was specifically rejected. The Report of the House Committee on Ways and Means states:

> Consideration has been given to suggestions by the Federal Power Commission and others that regulated utilities no longer be permitted to use a method of depreciation other than straight line. However, your committee concluded that, in too many cases, this would place regulated utilities at an unfair competi-

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[28] See note 7, *supra* (emphasis added).

tive disadvantage, both in terms of the sale of their products or services and their attractiveness to equity investors. Also, this would result in prompt, substantial, and widespread utility rate increases.

Accordingly, your committee has determined in general to "freeze" the current situation regarding methods of depreciation in the case of those companies in what are, by and large, the more healthy utility industries.[29]

The Senate Report agreed with this perspective, stating in relevant part:

> Accordingly, the committee agrees with the House that it is *appropriate to in general* [sic] *'freeze' the current situation regarding methods of depreciation* in the case of those companies in what are, by and large, the more flourishing utility industries.[30]

The Senate Report, agreeing that a company using straight-line depreciation with normalization could not shift to flow-through under the bill, stated, with specific reference to utility companies such as Texas Gas which have been using liberalized depreciation with flow-through, "[o]ther companies—those that now flow through, as well as those in other regulated industries—are not limited by this general rule of the bill."[31]

Also, as the Summary of the Bill, prepared by the staffs of the Joint Committee on Internal Revenue Taxation and the Committee on Finance, observes with respect to the impact of Section 441(a) on revenues as well as rates:

> The bill substantially forestalls the entire revenue loss that the continuation of existing trends would have made almost inevitable. It does so in a way that (with very few exceptions) will require no increase in utility rates because of the tax laws, since

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[29] See note 26, *supra* (emphasis added).

[30] See note 6, *supra* (emphasis added).

[31] *Id.*, at 174.

> by and large, it merely takes the various regulatory situations as it finds them and freezes those situations.[32]

There is nothing in the Tax Reform Act of 1969, then, which modifies the Commission's duty under the Natural Gas Act to require regulated utility companies such as Texas Gas, which had been using liberalized depreciation with flow-through with respect to their pre-1970 and post-1969 non-expansion property, to set rates which reflect actual expenditures alone with respect to such property. According to Congress, the only appropriate tax allowance for ratemaking purposes for a company such as Texas Gas, which has been using liberalized depreciation with flow-through with respect to its pre-1970 and post-1969 non-expansion property, is the income taxes actually paid.[33]

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[32] Summary of the Bill, prepared by the staff of the Joint Committee on Internal Revenue Taxation and the Committee on Finance, at 73.

[33] In a recent analogous case, the California Supreme Court held that Pacific Telephone and Telegraph Company's refusal, despite the fact that the California Public Utilities Commission was imputing accelerated depreciation with flow-through to those utilities which, like Pacific Telephone, used straight-line depreciation, to abandon straight-line depreciation (even though this meant a higher tax burden for Pacific Telephone in light of its expanding plant) [See pp. 4-5 of Slip Op.] was an "imprudent management decision" which it should not be permitted to pass on to its customers by means of higher rates. As the court there noted,

> . . . [I]t is clear that requiring ratepayers to put up the capital for the telephone system is contrary to the basic principle of utility rate setting. The basic principle is to establish a rate which will permit the utility to recover its cost and expenses plus a reasonable return on the value of property devoted to public use. . . . By permitting Pacific to include in its costs a charge for federal taxes greatly in excess of its actual federal tax ex-

B.

The FPC has argued that there is nothing in this Tax Reform Act indicating an intent on the part of Congress to alter the Commission's power to exercise its informed judgment as to what method of accounting can properly serve as the basis of ratemaking, and to weigh the cost to the consumer and the necessity to preserve a viable industry. The FPC urges that had Congress had such an intent, Congress would have manifested it by an amendment to the Natural Gas Act, not to a Revenue Act.

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pense, the Commission is deviating from this basic principle. We realize that the 1968 commission decision also deviated from the basic principle by refusing to permit Pacific to include in its costs all of its tax expense, but this deviation was based on Pacific's imprudent management.

It should also be pointed out that the effect of the instant decision [of the Commission below] is to reward Pacific for its imprudent management as compared to other utilities which prudently had adopted accelerated depreciation and flow-through prior to August 1969. Apparently, these utilities will continue to be required to flow-through the benefits of accelerated depreciation to the ratepayers, whereas Pacific will be allowed to use accelerated depreciation [under the Commission's decision below] without requiring flow-through, thus retaining most of the benefits for itself.

In the circumstances, we are satisfied that, in the light of Pacific's past imprudence, the commission could reasonably have ordered Pacific to continue the accounting practices established in the 1968 decision and that the commission abused its discretion in expressly *refusing to consider* imputed acceleration depreciation and flow-through as established in the 1968 decision.

City and County of San Francisco v. *Public Utilities Commission et al.*, S.F. 22794, & *Consumers Arise Now et al.* v. *Public Utilities Commission and Pacific Telephone and Telegraph Company*, S.F. 22793, pp. 15-16, Slip Op. (emphasis in original).

This overlooks the undeniable fact that methods of calculating depreciation are relevant both for taxation and ratemaking purposes. Congress here dealt with depreciation in the context of a revenue measure, but all its deliberations—particularly the committee reports of both houses, the conference committee report, and most significantly, the changes made in the bill at different stages—show its keen awareness of the measure's impact on the federal revenue, the natural gas industry, and the consumers. It may well be that some of the FPC's regulatory discretion has been lost by the enactment of this law; in effect, Congress has pondered the question, and has exercised what formerly was the FPC's perogative for it. The fact that Congress did so in the context of a Tax Reform Act cannot vitiate what Congress enacted.

To hold otherwise would be to rule that the carefully considered changes, granting an election to the company with respect to its expansion property but eliminating any choice by either company or FPC with respect to the company's *non*-expansion property,[34] were meaningless. The rule here urged by the FPC and Texas Gas is similar to that policy proposed by Chairman White, and this was rejected.[35] We here give effect to what Congress did; albeit cloaked in a revenue act, a statutory mandate in regard to the calculation of depreciation has an effect on the FPC's power to exercise its independent judgment as to what best will serve industry and consumers.

Our holding, however, should not be taken to mean that Section 441(a) of the Tax Reform Act of 1969 deprives the Commission in all cases of its discretion under the Natural Gas Act to permit utilities to abandon flow-through. There might be extraordinary circumstances in

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[34] See notes 3 and 28, *supra*.

[35] See note 26, *supra*.

which Section 441(a), taken in conjunction with the mandate of the Natural Gas Act, should not be construed to prevent the FPC in its underlying responsibility of protecting consumer interests from finding that those interests would be furthered by permitting the abandonment of flow-through. It is clear, however, that such consumer interests would not be furthered by permitting Texas Gas to abandon flow-through in the circumstances presented by the case at bar.

III.

Accordingly, the decision of the Federal Power Commission in its Orders No. 404 and 404-A with respect to the post-1969 *expansion* property of Texas Gas—the subject of cases no. 24,518 and 24,602—is affirmed. However, the action of the Commission in its Opinions No. 578 and 578-A and accompanying orders in regard to Texas Gas' pre-1970 and post-1969 *non*-expansion property—the subject of cases no. 24,517 and 24,632—is vacated and remanded to the Commission for action in accordance with this opinion.

SO ORDERED.

APPENDIX B

[Docketed May 15, 1970]

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

[18 C.F.R. 2.12, 2.67]

Before Commissioners: John N. Nassikas, Chairman; Lawrence J. O'Connor, Jr., Carl E. Bagge, John A. Carver, Jr., and Albert B. Brooke, Jr.

Docket No. R-387

CALCULATION OF TAXES FOR PROPERTY OF PUBLIC UTILITIES, LICENSEES AND NATURAL GAS PIPELINE COMPANIES CONSTRUCTED OR ACQUIRED AFTER JANUARY 1, 1970

Order No. 404

STATEMENT OF POLICY

(Issued May 15, 1970)

Section 441 of the Tax Reform Act of 1969, 83 Stat. 487, *et seq.*, which relates to depreciation allowance for regulated industries provides, in substance, the following with respect to certain types of public utility property, including property of electric and natural gas pipeline companies:

(a) If straight-line depreciation is presently being used, it must continue to be used for existing property or property in the hands of a utility at any time before January 1, 1970; for property constructed or acquired thereafter the utility may continue on the straight-line method, or it may change to a liberalized method providing it follows a normalization method of accounting;

(b) If a normalized method has been used it may continue to be used both for existing property and

for property constructed or acquired after January 1, 1970; or the utility may change to straight-line depreciation for both kinds of property; and

(c) If the flow-through method of accounting is presently being used it may continue to be used for both existing and new property; however, for property constructed or acquired after January 1, 1970, to the extent to which such property increases the productive or operational capacity of the utility and is not a replacement

of existing capacity, the utility may elect within 180 days of the enactment of the Act to change to a straight-line method, or, if permitted to do so by the appropriate regulatory authority, to a normalization method.

We should, therefore, determine whether it is appropriate to permit a normalization method of accounting for property as to which the election described in subparagraph (c) above may be exercised. Normalization results in a sharing of such tax benefits by consumers and regulated companies. Accordingly, in light of the above described changes in the Internal Revenue Code, it is in the public interest, as to property as to which such election is made, that electric and natural gas pipeline companies regulated by the Commission be permitted to employ a normalization method in their accounts and annual reports, as well as for ratemaking purposes.[1] It will remain our policy as decided in *Alabama-Tennessee Nat-*

[1] This policy statement does not purport to decide either the ratemaking or accounting issues with respect to property constructed or acquired prior to January 1, 1970, on which liberalized depreciation is now being taken and flow-through accounting is being used. These issues will be decided in a future proceeding.

ural Gas Co., 31 FPC 208, modified 31 FPC 928 (1964), affirmed, *sub nom. Alabama-Tennessee Natural Gas Co.* v. *F.P.C.*, 359 F. 2d 318 (CA5), certiorari denied, 385 U.S. 846 (1966), to deduct the balances in Account No. 282 of the Uniform System of Accounts from rate base and not to consider such balances as part of capitalization in rate proceedings before the Commission.

Regulated Companies which file an election with the Internal Revenue Service pursuant to § 441, supra, should file a copy with this Commission.

The Commission finds:

(1) It is appropriate and necessary for carrying out the provisions of the Federal Power Act and the Natural Gas Act that electric and natural gas pipeline companies be permitted to employ normalization accounting for liberalized depreciation for property constructed or acquired after January 1, 1970, to the extent which such property increases the productive or operational capacity of the utility and is not a replacement of existing capacity, if the election permitted by Section 441(a)(4)(A) of the Tax Reform Act of 1969 has been exercised.

(2) Since the statement issued herein concerns a matter of general policy, compliance with the provisions of 5 U.S.C.

553, relating to notice and hearing is unnecessary and the statement may be made effective upon issuance.

The Commission, acting pursuant to authority granted by the Federal Power Act, as amended, particularly Sections 205, 206, 301, 302, 304 and 309 thereof (49 Stat. 851, 852, 854, 855, 858; 16 U.S.C. 824d, 824e, 825, 825a, 825c, 825h), and by the Natural Gas Act, as amended, particularly Sections 4, 5, 8, 9, 10 and 16 thereof (52 Stat. 822, 823,

825, 826, 830; 76 Stat. 72; 15 U.S.C. 717c, 717d, 717g, 717h, 717i, 717o), *orders*:

(A) Part 2, General Policy and Interpretations, Subchapter A, Chapter I of Title 18 of the Code of Federal Regulations is amended by adding a new Section 2.12, entitled "Calculation of Taxes for Property of Public Utilities and Licensees Constructed or Acquired after January 1, 1970," as follows:

§ 2.12 *Calculation of Taxes for Property of Public Utilities and Licensees Constructed or Acquired After January 1, 1970*

Pursuant to the provisions of Section 441(a)(4)(A) of the Tax Reform Act of 1969, 83 Stat. 487, 625, public utilities and licensees regulated by the Commission under the Federal Power Act which have exercised the option provided by that section to change from flow through accounting will be permitted by the Commission, with respect to liberalized depreciation, to employ a normalization method for computing federal income taxes in their accounts and annual reports with respect to property constructed or acquired after January 1, 1970, to the extent with which such property increases the productive or operational capacity of the utility and is not a replacement of existing capacity. Such normalization will also be permitted for ratemaking purposes to the extent such rates are subject to the Commission's ratemaking authority. As to balances in Account No. 282 of the Uniform System of Accounts, "Accumulated deferred income taxes—liberalized depreciation," it will remain the Commission's policy to deduct such balances from rate base in rate proceedings. (Secs. 205, 206, 301, 302, 304, 309; 49 Stat. 851, 852, 854, 855, 858; 16 U.S.C. 824d, 824e, 825a, 825c, 825h.)

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

[18 C.F.R. 2.12, 2.67]

Docketed Jul 9-1970

Before Commissioners: John N. Nassikas, Chairman; Lawrence J. O'Connor, Jr., Carl E. Bagge, John A. Carver, Jr., and Albert B. Brooke, Jr.

Calculation of Taxes for Property of Public Utilities, Licensees, and Natural Gas Pipeline Companies Constructed or Acquired After January 1, 1970

Docket No. R-387

Order No. 404-A

Order Denying Rehearing

(Issued July 9, 1970)

On June 12, 1970, applications or petitions for rehearing of the Commission's Order No. 404, issued May 15, 1970, were filed by American Public Gas Association (APGA); Memphis Light, Gas & Water Division (Memphis); and Tennessee Valley Municipal Gas Association (Tennessee Valley). In that order we announced the general policy that electric and natural gas pipeline companies will be permitted to employ normalization accounting for liberalized depreciation for property constructed or acquired after January 1, 1970, to the extent to which such property increases the productive or operational capacity of the utility and not a replacement of existing capacity, if the election permitted by Section 441(a)(4)(A) of the Tax Reform Act of 1969 has been exercised. Such normalization will, we said, also be permitted for ratemaking purposes to the extent such rates are subject to the Commission's ratemaking authority.

The specifications of errors of Memphis and Tennessee Valley are identical and will be referred to herein as Tennessee Valley.

The petition of Tennessee Valley contends that Order No. 404 is unlawful because:

(1) it was adopted without notice or opportunity for hearing and is a denial of due process of law;

(2) it lacks essential and adequate findings of fact;

(3) it requires customers to contribute capital to the pipeline; and

(4) the conclusion that normalization results in a sharing of benefits of liberalized tax depreciation by regulated companies and consumers is erroneous.

In Section 441(a)(4)(A) of the Tax Reform Act of 1969, Congress gave natural gas pipeline companies, among others, the absolute right to change from accelerated tax depreciation with flow-through to straight-line tax depreciation with respect to specific properties. Regulatory agencies, including this Commission, are powerless to vitiate that right by imputing the use of liberalized depreciation with flow-through and flowing the benefits thereof through to customers. The only other option open to a natural gas pipeline company making the election under Section 441(a)(4)(A) is liberalized depreciation with normalization if such normalization is permitted by the appropriate regulatory authority. Under these circumstances the Commission was faced squarely with the question of whether it should require companies, which exercised the right, to remain on straight-line or whether it should, in the public interest, permit such companies to revert back to liberalized depreciation with normalization. Any argument, under these conditions comparing the merits of flow-

through and normalization tax accounting methods is irrelevant since the only available choice is between normalization and straight-line. Order No. 404 recognizes the election provisions available under the Tax Reform Act of 1969 and reaffirms the essence of our previous finding that liberalized depreciation with normalization is preferable to straight-line. *Northern Natural Gas Co,.* 25 FPC 431 (1961).

Rates will, when a company initially uses liberalized depreciation with normalization, be the same as they would have been if straight-line tax depreciation had been employed. Additionally, we announced in Order No. 404 that we would continue our present policy of deducting the amounts in accrued tax deferral accounts from rate base. Hence, rather than a deprivation of property, Order No. 404 reaffirms our resolve to extend to ratepayers, to the extent permitted by law, the benefits of the use of liberalized tax depreciation with normalization.

The only factual findings necessary to Order No. 404 are that Congress included in the Tax Reform Act of 1969 a provision granting natural gas pipeline companies, among others, the absolute right to change from liberalized depreciation with flow-through to straight-line and prohibited companies which exercised

that right from returning to liberalized tax depreciation with flow-through. We are satisfied that Congress did include such provisions in the Tax Reform Act of 1969.

The use of straight-line depreciation eliminates the possibility of tax deferrals to natural gas pipeline companies. On the other hand, liberalized depreciation with normalization may generate substantial tax deferrals. The benefits of these tax deferrals are shared, although admittedly not necessarily in equal proportions, by the company and

its customers by treating such amounts as rate base deductions.

APGA cites alleged errors in Order No. 404 similar, in substance, to those advanced by Tennessee Valley and, in addition, asserts that Order No. 404 was not warranted by the Tax Reform Act of 1969. In addition to seeking rehearing, APGA petitions us to stay the effectiveness of that order pending final determination of this case.

With respect to APGA's assertion that Order No. 404 was not warranted by the Tax Reform Act of 1969, APGA apparently reads more into the order than is there. APGA criticizes our abandonment of flow-through with regard to post-1969 expansion property as being not required by the Act. APGA is, in our opinion, quite right in stating that the abandonment of flow-through is not required by the Act, but APGA errs when it concludes that we abandoned flow-through for such property. Our first finding in Order No. 404 is:

> It is appropriate and necessary for carrying out the provisions of the Federal Power Act and the Natural Gas Act that electric and natural gas pipeline companies be permitted to employ normalization accounting for liberalized depreciation for property constructed or acquired after January 1, 1970, to the extent to which such property increases the productive or operational capacity of the utility and is not a replacement of existing capacity, *if the election permitted by Section 441(a)(4)(A) of the Tax Reform Act of 1969 has been exercised.* [Emphasis supplied.]

The underlined language clearly indicates that Order No. 404 is limited in its application to situations in which the company has exercised its statutory right to revert to straight-line for post-1969 expansion property. As to all other property, Order No. 404 in no way affects flow-through.

APGA asserts further that our permission to use normalization will induce the industry to switch from flow-through at the direct expense of consumers. This is, of course, nothing

more than unsupported conjecture and speculation. We do, however, summarily reject the implied suggestion that this Commission should refuse to inform companies, over whom we have been given regulatory jurisdiction, of our general policy in respect to any matter of concern to them.

The Commission finds:

(1) Order No. 404 is a statement of general policy interpreting the mandate of Congress; it does not independently create any rights, duties or obligations of natural gas pipeline companies or their customers; and therefore, notice and opportunity for hearing thereon is unnecessary.

(2) Substantial and adequate grounds for the adoption of Order No. 404 exist in Commission precedents and in the Tax Reform Act of 1969, and further hearings in this case would serve no useful purpose.

(3) To stay the effectiveness of Order No. 404 is not in the public interest.

The Commission orders:

The applications for rehearing of Memphis and Tennessee Valley, and the petition for rehearing and stay of APGA are denied.

By the Commission.

(SEAL)

GORDON M. GRANT,
Secretary.

APPENDIX C

Excerpts from Section 441 of the Tax Reform Act of 1969:

(*l*) Reasonable allowance in case of property of certain utilities.—

(1) Pre-1970 public utility property.—

(A) In general.—In the case of any pre-1970 public utility property, the term "reasonable allowance" as used in subsection (a) means an allowance computed under—

(i) a subsection (*l*) method, or

(ii) the applicable 1968 method for such property.

Except as provided in subparagraph (B), clause (ii) shall apply only if the taxpayer uses a normalization method of accounting.

(B) Flow-through method of accounting in certain cases.—In the case of any pre-1970 public utility property, the taxpayer may use the applicable 1968 method for such property if—

(i) the taxpayer used a flow-through method of accounting for such property for its July 1969 accounting period, or

(ii) the first accounting period with respect to such property is after the July 1969 accounting period, and the taxpayer used a flow-through method of accounting for its July 1969 accounting period for the property on the basis of which the applicable 1968 method for the property in question is established.

(2) Post-1969 public utility property.—In the case of any post-1969 public utility property, the term "reasonable allowance" as used in subsection (a) means an allowance computed under—

(A) a subsection (*l*) method,

(B) a method otherwise allowable under this section if the taxpayer uses a normalization method of accounting, or

(C) the applicable 1968 method, if, with respect to its pre-1970 public utility property of the same (or similar) kind most recently placed in service the taxpayer used a flow-through method of accounting for its July 1969 accounting period.

(3) Definitions.—For purposes of this subsection—

(A) Public utility property.—The term "public utility property" means property used predominantly in the trade or business of the furnishing or sale of—

(i) electrical energy, water, or sewage disposal services,

(ii) gas or steam through a local distribution system,

(iii) telephone services, or other communication services if furnished or sold by the Communications Satellite Corporation for purposes authorized by the Communications Satellite Act of 1962 (47 U.S.C. 701), or

(iv) transportation of gas or steam by pipeline,

if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, or by a public service or public utility commission or other similar body of any State or political subdivision thereof.

(B) Pre-1970 public utility property.—The term "pre-1970 public utility property" means property which was public utility property in the hands of any person at any time before January 1, 1970.

(C) Post-1969 public utility property.—The term "post-1969 public utility property" means any public utility property which is not pre-1970 public utility property.

(D) Applicable 1968 method.—The term "applicable 1968 method" means, with respect to any public utility property—

(i) the method of depreciation used on a return with respect to such property for the latest taxable year for which a return was filed before August 1, 1969,

(ii) if clause (i) does not apply, the method used by the taxpayer on a return for the latest taxable year for which a return was filed before August 1, 1969, with respect to its public utility property of the same kind (or if there is no property of the same kind, property of the most similar kind) most recently placed in service, or

(iii) if neither clause (i) nor (ii) applies, a subsection (*l*) method.

In the case of any section 1250 property to which subsection (j) applies, the term "applicable 1968 method" means the method permitted under subsection (j) which is most nearly comparable to the applicable 1968 method determined under the preceding sentence.

(E) Applicable 1968 method in certain cases.—If the taxpayer evidenced the intent to use a method of depreciation (other than its applicable 1968 method or a subsection (*l*) method) with respect to any public utility property in a timely application for change of accounting method filed before August 1, 1969, or in the computation of its tax expense for purposes of reflecting operating results in its regulated books of account for its July 1969 accounting period, such other method shall be deemed to be its applicable 1968 method with respect to such property and public utility property of the same (or similar) kind subsequently placed in service.

(F) Subsection (*l*) method.—The term "subsection (*l*) method" means any method determined by the Secretary or his delegate to result in a reasonable allowance under subsection (a), other than (i) a declining balance method, (ii) the sum of the years-digits method, or (iii) any other method allowable solely by reason of the application of subsection (b) (4) or (j) (1) (C).

(G) Normalization method of accounting.—In order to use a normalization method of accounting with respect to any public utility property—

(i) the taxpayer must use the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account, and

(ii) if, to compute its allowance for depreciation under this section, it uses a method of depreciation other than the method it used for the purposes described in clause (i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from the use of such different methods of depreciation.

(H) Flow-through method of accounting.—The taxpayer used a "flow-through method of accounting" with respect to any public utility property if it used the same method of depreciation (other than a subsection (*l*) method) to compute its allowance for depreciation under this section and to compute its tax expense for purposes of reflecting operating results in its regulated books of account.

(I) July 1969 accounting period.—The term "July 1969 accounting period" means the taxpayer's latest accounting period ending before August 1, 1969, for which it computed its tax expense for purposes of reflecting operating results in its regulated books of account.

For purposes of this paragraph, different declining balance rates shall be treated as different methods of depreciation.

(4) Special rules as to flow-through method.—

(A) Election as to new property representing growth in capacity.—If the taxpayer makes an election under this subparagraph within 180 days after the date of the enactment of this subparagraph in the manner prescribed by the Secretary or his delegate, in the case of taxable years beginning after December 31, 1970, paragraph (2) (C) shall not apply with respect to any post-1969 public utility property, to the extent that such property constitutes property which increases the productive or operational capacity of the taxpayer with respect to the goods or services described in paragraph (3) (A) and does not represent the replacement of existing capacity.

(B) Certain pending applications for changes in method.—In applying paragraph (1) (B), the taxpayer shall be deemed to have used a flow-through method of accounting for its July 1969 accounting period with respect to any pre-1970 public utility property for which it filed a timely application for change of accounting method before August 1, 1969, if with respect to public utility property of the same (or similar) kind most recently placed in service, it used a flow-through method of accounting for its July 1969 accounting period.

(5) Reorganizations, assets acquisitions, etc.—If by reason of a corporate reorganization, by reason of any other acquisition of the assets of one taxpayer by another taxpayer, by reason of the fact that any trade or business of the taxpayer is subject to ratemaking by more than one body, or by reason of other circumstances, the application of any provisions of this subsection to any public utility property does not carry out the purposes of this subsection, the Secretary or his delegate shall provide by regulations for the application of such provisions in a manner consistent with the purposes of this subsection.